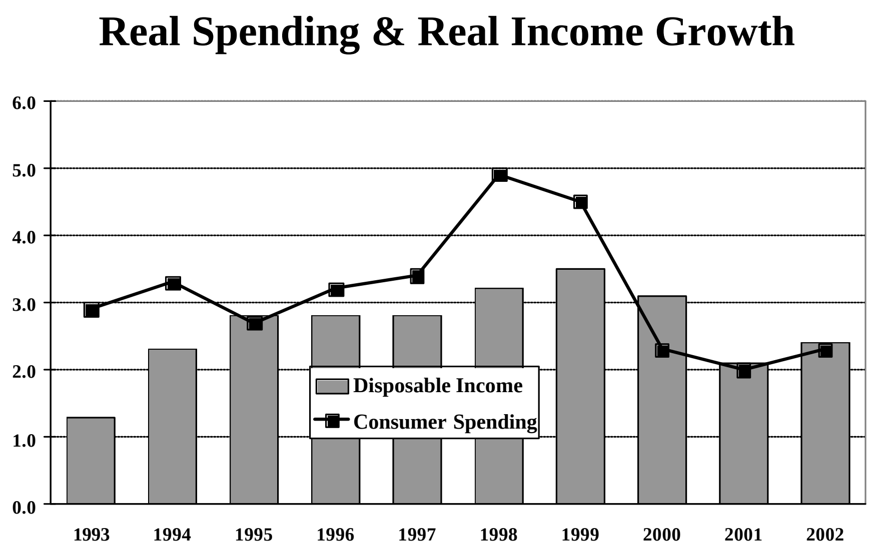
NATIONAL FORECAST DESCRIPTION
The Forecast Period is the First Quarter of 1999 to the Fourth Quarter of 2002

The U.S. economy continued its steady march this spring toward being the longest expansion. With less than a year to go and no major imbalances in sight, the old record of 106 straight months of growth set from February 1961 to December 1969 is expected to fall. Almost eight years into the current expansion, the economy still shows incredible strength. Real GDP, the broadest measure of the economy's strength, grew at a 4.3% annual rate in this year's first quarter. Noticeably absent, however, were the imbalances that foreshadow a recession. Most significantly, inflation remains in check. There are several reasons inflation remains well behaved. First, employee compensation has been growing slowly in spite of the tight labor market. Second, there has been a large manufacturing capacity surplus in the U.S. and abroad. Third, U.S. businesses have been hesitant to raise prices in order to retain hard-earned market share. Fourth, soft farm prices and the drop in the oil price in 1998 have helped keep overall inflation in check. The lack of imbalances is significant because the current recovery is old by historical standards, making a recession overdue. Not all the news for the economy is positive; trade remains a drag on the economy. Thanks to the U.S.'s position as the world's strongest economy, the trade deficit has ballooned. While this may slow economic growth, it will not stop it. The U.S. economy should continue expanding through 2002. Specifically, real GDP advances 3.9% in 1999, 2.0% in 2000, 2.1% in 2001, and 2.6% in 2002.

Many people not only welcome the continued economic growth, they are counting on it. President Clinton announced a plan to retire the federal debt within the next 15 years. While this may be a noble pursuit, it may not be a realistic one. The success of his plan hinges on the economy expanding continuously until the debt is gone. This assumes the economy will expand for over two decades without suffering a recession. This would be unprecedented, if not impossible. This implies the business cycle is dead or at least in a deep coma. The President is not the only optimist. Congressional leaders have been pushing for a tax cut. Both plans could have dire consequences if a recession occurs. This is because a recession hurts the budget in two ways. When jobs are lost the flow of tax revenue into government coffers falls off. In addition, more government services are demanded. Thus, lower receipts and higher outlays squeeze the federal budget. Under such conditions, the President may not only have to abandon his plan to retire the debt, but find himself dealing with a budget deficit again.

Although the current forecast assumes there will not be a recession over the next few years, it is not entirely out of the realm of possibility. For example, DRI has prepared two alternative forecasts that include recessions. The near-term risk to the U.S. forecast continues to be a major stock market correction. Because Americans' low savings rate is driven by the high wealth/income ratio, spending may be more sensitive to a drop in the stock market than in the past. A decline in share prices could quickly undermine consumer confidence, and thus consumer spending. One scenario assumes such a correction occurs in 2000. This leads to a mild recession that same year. In another scenario, the U.S. economy grows stronger in 1999-2000 than projected. But there is a high cost associated with the good times. Tighter labor markets push inflation higher. More importantly, commodity prices, including oil, rebound as foreign economies recover and the U.S. economy surges. As inflationary pressures bubble to the surface, the Federal Reserve raises interest rates sharply beginning in late 2000. In addition, a stock market correction hits during this period. The combination of higher interest rates and damaged consumer confidence hurts consumer spending, especially for large-ticket items. The economy falls into a recession in 2001.

SELECTED NATIONAL ECONOMIC INDICATORS



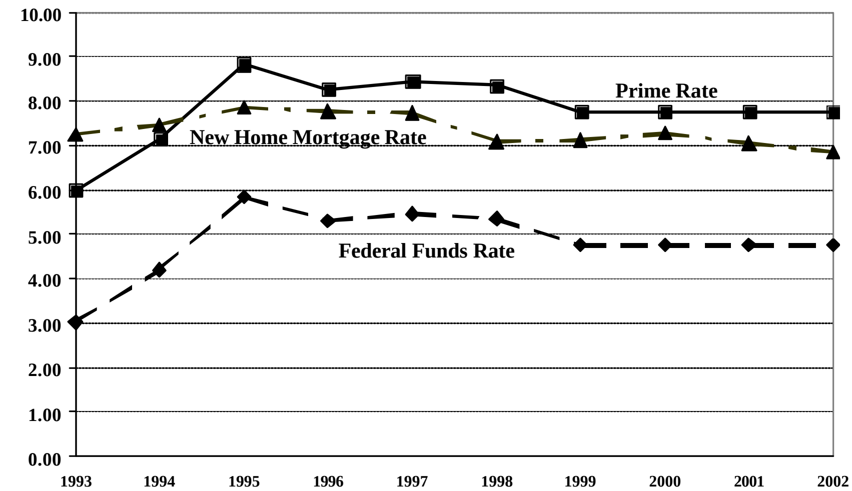
Source: Standard and Poor's DRI

Consumer Spending: The American consumers' spending spree should continue through this year. For most of this decade real consumer spending has grown faster than real disposable personal income. As a result, the personal savings rate has fallen from nearly 6.0% in 1992 to virtually zero in 1998. In addition, the ratio of outstanding credit to disposable personal income soared from about 17.0% to just over 21.0% over this same period, a new record. This seemingly spendthrift behavior raises questions of why Americans have been spending so freely and how much longer they are willing to out spend their income. There are several reasons for consumers' recent spending habits. First, the record runup in the stock market has produced a substantial wealth effect. The Standard and Poor 500 Index has more than doubled from 1992 to 1998. The value of real household assets have also shot up, growing by over 9.0% per year since 1994. Second, low interest rates have encouraged mortgage refinancings and home equity borrowing. Third, the current expansion has not only produced strong employment and income growth, but it appears to have changed consumers' expectations. Indeed, Americans apparently believe that steady economic growth and low inflation will protect their income gains. This rise in confidence has boosted durable goods sales, as consumers are more willing to take on big-ticket purchases. A good example of this is the surge in light vehicle sales (cars and light trucks, including SUVs). Coming out of the recession, consumers were understandably hesitant to purchase vehicles. In 1992, about 13 million light vehicles were sold. In comparison, in May of this year light vehicles were selling at an astounding 17.3 million units annual rate. In addition to the robust economy, attractive pricing, low interest rates and the growing popularity of leasing are enhancing the strength of vehicle sales. The latter helps sales because the average lease life of about three years has increased the frequency of new vehicle acquisitions. The future is not without risks, however. Of major concern is whether the current low savings rate is too thin a cushion for consumers to fall back on. Several factors suggest this will not be a problem in the short term. First, official statistics under report personal savings because they do not count capital gains in personal income but they subtract the taxes paid on those gains to arrive at disposable personal income. Second, savings in the stock market are quite liquid, and a 401k can be used as collateral, much like savings. Third, although consumer debt is high, low interest rates have kept the debt-service burden reasonable. However, even these factors cannot keep spending aloft forever. Eventually the stock market will not be able to keep up its recent pace, and this will weigh down future real household asset gains. In addition, slower future job growth will also dampen consumer confidence. As a result of these factors, real consumer spending growth is expected to fall in line with real disposable income growth. <u>Specifically, real spending is projected to rise 4.5% this year, 2.3% next year, 2.0% in 2001, and 2.3% in 2002.</u>

Financial: To almost no one's surprise, the Federal Open Market Committee announced on June 30, 1999 that it was raising the federal funds rate 25 basis points to 5.00%. After raising the rate, the

Federal Reserve was quick to add that it is taking a neutral stance. This is a change from last fall, when the Federal Reserve, in an effort to keep the economy moving, lowered the federal funds rate in three quick moves. The strong growth of real GDP in both the last quarter of 1998 and the first quarter of 1999 suggests that this policy has been successful. Unlike last fall, there was not a clear reason to raise rates this spring. Inflation, except for a temporary jump in April, seemed well under control. However, the Federal Reserve's move should be viewed as a preemptive strike to keep the economy from over heating. Although almost everyone knew the Federal Reserve would raise rates, not everyone agreed with this move. For example, DRI believed the economy would slow down without the central bank's intervention, and any tightening could be safely postponed. It should also be pointed out that the decision to tighten was not a straightforward one. There are several risks associated with tightening. First, if DRI was right and the economy would have slowed on its own, the higher interest rates could push the economy into a recession. The higher interest rates could also hurt the nation's already weak trade situation. Rising interest rates tend to raise the value of the dollar, which makes U.S. products more expensive in the global market. This is a concern because the European Central Bank has been cutting its interest rates, which has caused the newly minted euro to fall relative to the U.S. dollar. The rise in the federal funds rate widens the chasm between domestic and European interest rates.

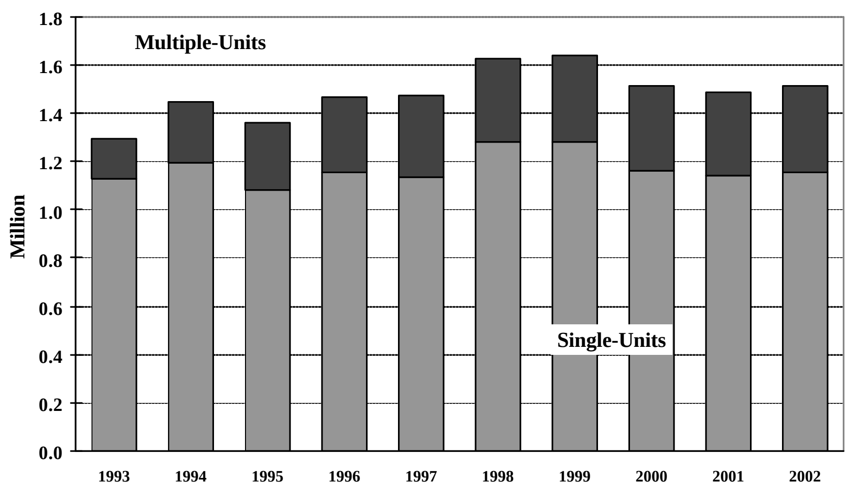
Selected Interest Rates



Source: Standard and Poor's DRI

Housing: The U.S. housing industry is expected to slow over the forecast period after enjoying a run of strong growth. This industry's recent string of success began in the mid-1990s, when housing starts went from 1.36 million units in 1995 to 1.47 million units in 1996. It remained at about that level in 1997, but to the surprise of many jumped 10% in 1998 to 1.62 million units—its strongest showing in over a decade. Other measures echo the strength of housing starts. Home sales flirted with the 5.9 million-unit level in 1998, which was about 600,000 stronger than in the previous year. Inflation-adjusted spending on residential structures rose 10.5% last year. Fueling this industry's growth was the fortuitous combination of plentiful jobs, low interest rates, and a booming stock market. All of these will also

U.S. Housing Starts

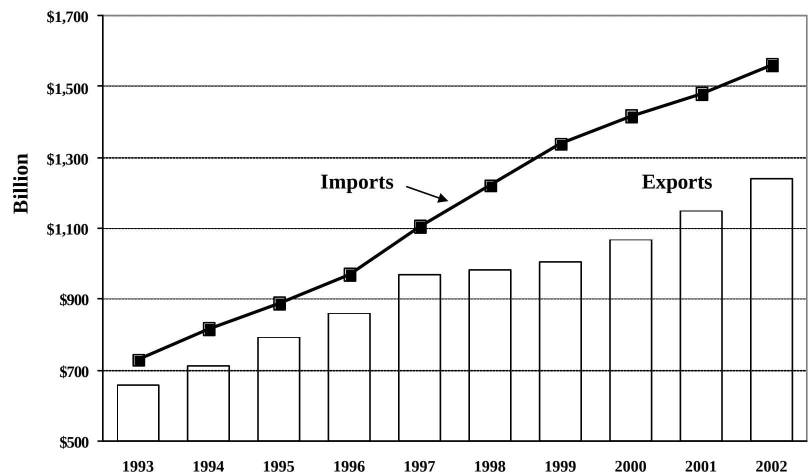


Source: Standard and Poor's DRI

determine this sector's path from here on out. So far this year, the housing industry has continued to soar. However, this was due in large part to unusual (and temporary) factors. For example, the nation's housing industry stayed hot all winter thanks to unusually mild weather conditions in many parts of the country. Estimated starts were boosted further by the seasonal adjustment process that assigns relatively more weight to winter housing starts. In fact, new housing was started at a 13-year high rate of 1.77 million units in the first quarter of this year, while single-family home starts set a 21-year record of 1.39 million units (annual rates). Eventually, even the high-flying housing industry will submit to softening fundamentals. The housing industry should have enough momentum to sustain a 1.6 million-unit pace this year. However, weaker job growth, higher interest rates, and smaller stock market gains will push starts below this level thereafter. Specifically, it was anticipated that there would be 1.64 million starts this year, 1.51 million in 2000, 1.49 million in 2001, and 1.51 million in 2002.

International: Trade is one of the few drags on an otherwise stellar U.S. economy. The U.S. trade deficit has widened as the expansion has aged. The current account deficit for merchandise and services has gone from $38.7 billion in 1992 to $169.3 billion in 1998. This change was caused by the deterioration of the merchandise component; it swelled from a deficit of $96.1 billion in 1992 to $248.2 billion in 1998. During this same period the U.S. built on its surplus of trade in services. The services trade surplus rose from $57.4 billion to $78.9 billion. Believe it or not, the trade situation has fared better than expected. In the early days of the Asian economic crises it was believed the U.S. trade deficit would be pummeled by a combination of factors. First, falling incomes abroad and the stronger dollar would hurt U.S. exports. Second, the strong dollar would make foreign imports more enticing to American consumers. Third, foreign countries would retreat to traditional strategies and attempt to export themselves back to prosperity. So far, only the first factor appears to have occurred with any significance. A look at the data shows that no flood of cheap imports has deluged the U.S. For example, the pace of real imports into the U.S. in 1998, while still high, was lower than in 1997. Conventional wisdom suggests that the pace of import growth should have quickened, not slackened. On the other hand, real exports, which had enjoyed 12.8% expansion in 1997, managed to eke out just 1.5% growth in 1998. Not surprisingly, the real net export deficit ballooned from $136.1 billion in 1997 to $238.2 billion in 1998. This deficit will continue to expand until improving foreign economies cause real exports to once again grow faster than real imports. While many of our trade partners' economies seemed to have turned the corner towards recovery, no improvement in the trade picture is expected until 2001. Specifically, the real net export deficit is forecast to be $330.8 billion in 1999, $350.8 billion in 2000, $332.5 billion in 2001, and $321.7 billion in 2002.

Real U.S. Imports and Exports



Source: Standard & Poor's DRI

Inflation: Inflation is expected to remain modest over the forecast period, despite its jump last spring. After posting its smallest gain since 1986 (1.5% in 1998), the consumer price index (CPI) jumped 0.7%

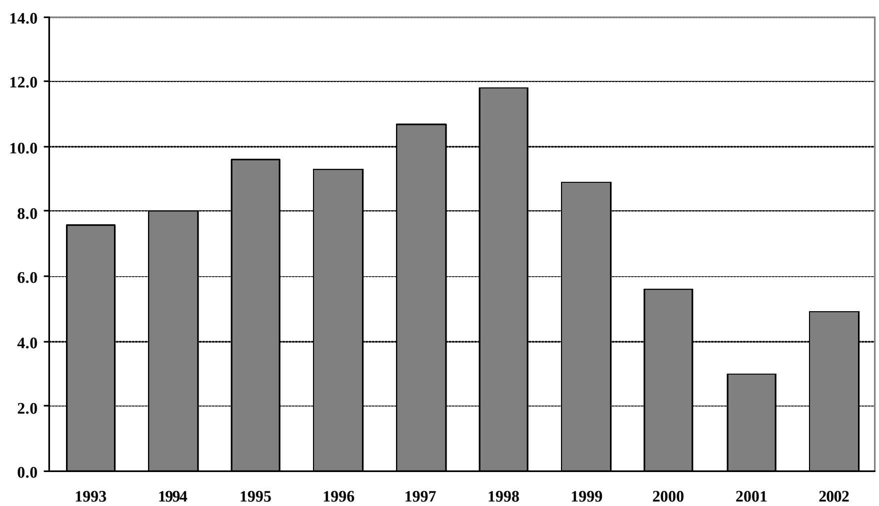
in April 1999. (This translates into an 8.7% annual inflation rate.) This set off warnings that inflation was back with a vengeance. However, a closer look reveals it was a false alarm. The April rise came in three primary areas. The first was energy prices, where the recent increase in oil prices caused gasoline prices to jump. The second was apparel, where the recent weakness of the dollar resulted in a sudden jump in clothing prices. Third, tobacco prices also rose. It should be pointed out that each of these increases marks the reversal of falling prices for these commodities. For example, the jump in gasoline prices reflects the rise in the refiners' acquisition price of imported crude from a depressed level of under $12 per barrel last winter to about $15 per barrel this spring. Even at $15 per barrel, oil is still considered a bargain. It should also be noted that all these impacts should be temporary. Again, using oil as an example. Oil prices jumped in response to the new OPEC production agreement. While members of the cartel have generally honored their quotas so far, these agreements are notoriously fragile because the incentives to cheat are high. This is especially true in several cash-strapped countries that need to get as much revenue from oil as possible. Thus, it seems unlikely that OPEC can control production enough to push the price of oil much higher. This being the case, one must look at employment costs to get an idea of where inflation is headed. Here is the good news — in the first quarter of this year the employment cost index was up only 3.4% from the previous year, despite the tightest job market in nearly three decades. It is believed that employment costs will rise near this level over the forecast period, and this will help dampen increases in other components of inflation. <u>The CPI is anticipated to increase 2.1% in 1999, 2.3% in 2000, and 2.5% in both 2001 and 2002.</u>

Employment: The U.S. employment situation is expected to soften over the forecast period. U.S. nonfarm employment posted back-to-back growth rates of 2.6% in both 1997 and 1998. This growth rate is projected to fall to 2.1% in 1999, then taper off to about 1.0% in the latter years of this forecast. Signs of a slowdown were already evident this spring. After increasing by 234,000 jobs in April, nonfarm employment added just 11,000 jobs in May. This was the smallest monthly increase since

January 1996. In addition, total jobs were up only 2.7 million from a year earlier, marking the smallest 12-month advance since October 1996. The manufacturing sector has been particularly hard hit. For example, this sector actually lost 45,000 jobs in May. This was another month in a downward trend. Since March of 1998, manufacturing has eliminated more than 450,000 jobs. Despite these job losses, U.S. manufacturing capacity continues to rise thanks to soaring productivity. Over the past three years, output per hour in manufacturing has averaged 4.5% growth per year, which was a percentage point faster than in the early 1990s. The job picture has been brighter for the service sector. It added more than one job for every job that was cut from the manufacturing sector. From 1997 to 1998, the number of service sector jobs expanded nearly 3.0%. Some may argue the economy will suffer because “good” manufacturing jobs are being replaced by “bad” service jobs. However, many of today’s service-sector jobs compare favorably with manufacturing-sector jobs. For instance, the average hourly wage in services was $13.32 in April, which was just about 50 cents less than in manufacturing. National nonfarm employment is forecast to rise 2.1% in 1999, 1.6% in 2000, 1.0% in 2001, and 1.1% in 2002. It should be pointed out that the civilian unemployment rate will rise slowly over this period, but it will remain well below the estimated full-employment mark of 5.5%.

Business Investment: Real business investment is projected to grow slower over the forecast period than it has in recent years. This will make it less of an engine of economic growth than it has been in the recent past. For the five years from 1992 to 1997, real investment spending growth averaged about 9.0% per year. During this same period the overall economy averaged about 3.0% annual growth. In fact, business investment has contributed more to the current expansion than to any of the other nine expansions since World War II. Indeed, one-fourth of the total GDP growth since 1991 has come from business investment, which is significantly larger than the average 15% share for the previous eight expansions. The strength in investment was due in large part the boom in producers’ durable equipment spending. Falling computer prices, strong profits, favorable credit conditions, and competition fueled it. As the economy cools in the future, so will the need for business investment. Over the forecast period real business investment should slow to 8.9% in 1999, 5.6% in 2000, 3.0% in 2001, and 4.9% in 2002. Over this same period, the gap between real investment growth and real GDP growth will narrow, going from five percentage points in 1999 to just over three percentage points in 2002.

Real Business Investment Growth



Source: Standard and Poor's DRI